



GLOBAL riskupdate



NOV / DEC 2012

The quarterly independent risk review for banks and financial institutions worldwide

Keynes' 'Animal Spirits' in the financial markets

Also in this issue

- Black Swans Mean Business
- How Canadian Banks have Managed the Economic Crisis so well
- OTC Clearing Evaluation of the EMIR and Dodd-Frank Regulations and their Impact on IT
- International Financial Supervisory Convergence

Keynes' 'Animal Spirits' in the financial markets: Is it time that 'Risk Management' should place greater focus on human emotions and their effect on financial decision-making?

Steven Goldstein is a qualified executive coach working with traders and portfolio managers to help them improve and enhance their personal trading performance in order to achieve greater success and improved profitability. Prior to working as a coach, Steven spent twenty-five years as a trader in the financial markets for a number of major banks and financial institutions. During this time Steven developed an in-depth understanding of financial markets, and the psychology and behavioural aspects associated with being a risk professional at the cutting edge of trading and investing.

This article introduces some new concepts and ideas about human decision-making, and considers some implications for the financial-market risk industry. It also looks at whether it needs to put into place changes in the way the financial risk management industry works and functions, in order to take greater account of aspects of human behaviour. Finally it looks at whether businesses can introduce improvements and enhancements to the way they work in order to prevent and mitigate risk, and to improve the quality of decision-making in the financial markets.

In John Maynard Keynes's celebrated 1936 book, 'The General Theory of Employment, Interest and Money', he used the term "Animal spirits" to describe emotions which influence human behaviour. Now, almost eight decades later, new research is shedding further light on these 'animal spirits', and in particular, how they affect people's decisions in the financial markets. Some of these findings are leading to questions about some of the basic assumptions of how people think and act, and are also challenging long-held beliefs and tenets central to economic theory. Whilst this has some direct consequences for the field of financial risk-management, it also provides new thinking and offers potential solutions, some of which may help to improve risk-management practices and techniques moving forward.

The traditional view from classical economics sees people as rational, utility-maximizing actors; individuals who know what they want and are consistent, methodical, and emotionless in pursuing it. Consistent with this is the view of the human mind as a machine; working like a computer and rationalizing all options through the use of people's cognitive powers, and the supremacy of intellect. These beliefs are cornerstones of modern economics, however, they are increasingly being challenged by the emerging fields of 'Behavioural Economics' and 'Neuroeconomics'. Backed by a growing body of research, they argue that



Keynes' 'Animal Spirits' in the financial markets

humans have many limitations to behaving rationally, as well as using feelings and emotions extensively when making decisions. One study which highlights this, looked into the decision-making performance of a group of highly qualified and experienced judges. The study involved 1,112 cases of parole board hearings over a 10 month period. One would expect that judge's rulings are based solely on rational decisions and written laws; however the research revealed that the biggest influence in the outcomes was actually the time of day of the hearings. Prisoners who appeared before the judges early in the morning session, straight after the mid-morning break, or immediately after the lunch break, received parole in about 60-70 percent of the cases. But, as each time period progressed, the percentage of successful appeals for parole decreased, with those appearing late in each session receiving parole no more than 10-15 percent of the time. The research found nothing malicious or unusual about the judges' behaviour; rather it was due to something known as 'Decision-fatigue'. 'Decision-fatigue' occurs as more choices are made throughout the day; each subsequent decision becomes harder for people's brains as it draws-down on energy in the form of glucose. In this case, no matter how rational and high-minded the judges tried to be, they were fighting their own human biology: The depletion of glucose to the judge's brains changed the way their thinking processes worked. This led them to non-consciously seek shortcuts which expended less energy; in most cases the shortcut involved 'decision-avoidance', which usually meant taking the default choice; to deny parole.

Further support arguing against the 'rational man' theory comes from neuroscience; increasing evidence is arguing for the primacy of emotions as a key part of decision-making. A study by neuroscientist Antonio Damasio, revealed how people who had received brain injuries which had resulted in a loss of ability to feel emotions, were incapable of making even the most basic of decisions; often spending hours deliberating over irrelevant details, such as where to eat lunch. The common belief is that the human mind uses purely cognitive process to reach logical conclusions, however as research into this field continues, these beliefs

and existing theories of rational decision-making are being seen as increasingly implausible. Damasio has labelled the popular belief of the mind acting independent of the body, as 'Descartes' Error'.

Coming back to financial markets, I want to look at what some implications from these alternative beliefs may be for financial risk-management, and to see whether these insights may offer steps towards improvements in the way financial risk management works. Much of the focus of risk management in the financial markets is on quantifying and measuring financial risk. A whole architecture of financial models, process and practices has arisen around this. However, what if the basic underlying assumptions that underpin some of these models are incorrect? The concept of 'rational man', largely underscores the long-standing assumption that markets are random, and that deviation from true value in liquid markets will be arbitrated away by 'rational-man'. As a participant in the financial markets for many years I have always disputed this assertion. Markets are human constructs, driven by human perceptions, reactions and decisions, which are largely triggered by people's emotions. Keynes understood the way markets worked from a behavioural perspective. In what was called the 'Keynesian beauty contest', he said, 'you win not by picking the soundest investment, but by picking the investment that others, who are playing the same game, will soon bid up higher'. It may be a stretch to say that because people act emotionally rather than rationally, that therefore markets are not random. However, it is this emotional human behaviour which leads to trends, manias, panics and long-term distortion from value, which are NOT quickly arbitrated away by the mythical 'rational man'.

If markets are not-random, then this calls into question many of the risk-management models which themselves are based



Keynes' 'Animal Spirits' in the financial markets

off this assumption, this is however further compounded by over-reliance on these models. The financial markets are obsessed with quantifying risk, yet even if these models are correct, they are merely tools which do not have predictive capabilities. Decisions around risk, should also involve subjective feeling and judgment based on expertise. Anurag Vaish of the 'Final Mile' consultancy, which specialises in finding risk solutions through neuroscience and behavioural economics, sums it up well: 'Risk is a feeling not a number; financial Institutions are highly number driven and continue to represent risk more as numbers'.

A further aspect of research into human behaviour is the realisation that we are not as in charge of the choices we make as we like to think we are. Our emotions affect our non-conscious thinking, which has a far greater pull over our behaviour than we realise. It is this non-conscious thinking, in collaboration with other inherent and learned human biases, which lead seemingly rational and intelligent people to make poor choices. This could help explain the prevalence of major human financial errors within financial businesses, e.g. JP Morgan, UBS, SocGen, Amaranth, etc. - Working on improving the monitoring of and quality of decision-making, is not merely a matter of risk-control and risk-mitigation, it is also a pro-active endeavour which can yield businesses a greater return on investment. Financial market businesses, via risk-management, could more closely monitor individual risk practices and behaviours. Steps could also be taken to deliver improved robustness and quality in individual, managerial and group decision-making. Input from risk practices in other industries may also provide potential solutions. For example, simple checklist practices have been put into place in industries as diverse as medicine and aviation, with profound effects on safety and quality. Also application of 'what-if-scenario' exercises in co-ordination with stress-testing (this is practiced in the disaster-recovery industry). Furthermore, businesses could look to redefine 'fit and proper' to move beyond meaning possessing 'honesty, integrity and reputation', to also include sufficiently qualified and educated in 'risk, products and markets'. A further step could be increased monitoring of individual behaviour using risk management systems together with subjective judgment; this could be done through highlighting specific individuals and particular risks for increased monitoring, possibly using a system of 'raised flags' for special attention.

Moving forward, it may take a break from past thinking to find solutions to some of the problems the industry faces. One interesting business which practices this is the 'Final-Mile' consultancy; they call their work 'Behavioural Architecture' and they look for and design alternative solutions to existing risk-orientated problems. A good example of their work, which received widespread global coverage, involved an experiment on a stretch of the Mumbai Rail system, notorious for deaths from people crossing rail tracks. As a result of some innovative recommendations they made which accounted for human decision-making and behaviour, deaths from rail-tracks crossings on a 1-mile stretch of line, dropped from 23 in the previous six months, to just one in the next eight months.

In the wake of the 'Global Financial Crisis', and subsequent strong political, regulatory and economic forces re-shaping the financial markets, the financial risk management industry is facing many challenges. Whilst it is unfair to apportion blame to the risk-management industry for the financial disasters of recent years, it is right to question some of its assumptions and practices, and to find out whether things could have been done better, and how things can be improved going forward. As part of this process, it may help to step away from some of the beliefs of the past, and to see if new innovative solutions could be found and applied to take the industry forward.

Steven Goldstein can be contacted via JK@riskrewardlimited.com

**the financial risk
management
industry is facing
many challenges**

For further information please contact:

Dennis Cox – CEO
telephone: +44 (0)20 7638 5558
email: DWC@riskrewardlimited.com

Lisette Mermod – New York
telephone: 1-917-310-1334
email: LM@riskrewardlimited.com

Joanna Kraska – Public Relations
telephone: +44 (0)20 7638 5558
email: JK@riskrewardlimited.com